
MEMORANDUM

TO: Michael Arnis

FROM: Deborah Chollet and James Matthisen **DATE:** 5/12/2008

SUBJECT: HIP Board Guidance on Small Group Rating in the Initial and Expanded HIP

This memorandum requests guidance from the HIP Board and/or HCA staff with respect to rating and employer contribution practices in both the initial and the expanded HIP. "List rating" is now used to calculate premiums by 5-year age intervals in the individual market, and we understand that the Board would retain list rating for individuals covered through the expanded HIP. The rest of this memo focuses on options for rating small groups in the expanded HIP.

As currently envisioned, two aspects of the HIP create particular challenges for rating small-group coverage:

- Small-group employees in the HIP would have unrestricted choice of plans within the HIP.
- The small-group and individual markets would be merged. That is, the same plans would be available to small-group employees and individuals at the same (per member per month) rates.

The implications for rating associated with each of these features of the HIP are discussed below, as informed by individual, hour-long discussions that we conducted with knowledgeable officials at Group Health, Premera, and Regence. We conclude with three specific questions for the Board. We request guidance on these questions before proceeding with the modeling.

I. Employee Choice of Plan

Unrestricted employee choice of plan creates some complexity both with respect to how the premium is calculated within groups, and how the employer contribution is calculated.

A. Small-Group Premium Calculation

All plans in the HIP would be available to small-group participants and individual participants on the same basis: employers and individuals alike could get from the HIP or a

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producer a table of rates by individual age within 5-year intervals.¹ If composite rating is used, a calculator on the HIP web site or the employer's producer could compute a "composite" rate for the small group—that is, for each plan in the HIP, the per-member-per-month rate if the employer's whole group chose to enroll in that plan (the same as in the current small group market).

An example of each alternative is developed below, illustrating the impact of applying list rating or composite rating to small groups in HIP. To simplify the examples, we assume that only employees (not also dependents) enroll in the plans. We assume that the employer contribution is calculated as a percent of a benchmark plan (as discussed later).²

1. List Rating

Employers would see HIP plan rates for each employee that are identical to those for individuals. Employees, then, would confront *individual variation* in their rates due to their age as well as their selection of a plan within the HIP.

In Figure 1, we assume the HIP offers 5 representative plans, with different benefits and cost sharing. ABC Hauling Company has three employees, aged 25-60. When ABC requests HIP rates for all available plans, it is given a rate quote for each worker for each plan. Employers would no longer average employees' rates to compute a single composite rate that would apply to all employees. Instead, each of ABC's three employees would pay the *list rate* for the plan he selects. Note that the rate each employee pays reflects his own age, as well as differences in plan benefits and cost sharing.

¹ Authorizing HIP legislation specifies that current small group regulation would prevail in the HIP. At present, carriers may vary rates by type of contract, geography, and age. Rates may vary by age within a band of 3.75:1.

² Note that if all or most employees chose a plan more expensive than the benchmark, it is possible that the employer's contribution to coverage could prove to be less than 40 percent of actual premiums. Conversely (and as in the examples) if employees chose plans that are less expensive than the benchmark, the employer might pay more than 40 percent of coverage—for the youngest employee in Figures 1 and 2, the full premium. But it would be impossible to know in advance what percentage the employer ultimately will pay—especially as the 75-percent participation rule could force the employer to contribute more than 40 percent against the benchmark. Also, if low-income workers selected more comprehensive coverage, either their contributions or the state's subsidy outlays could be higher than anticipated.

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FIGURE 1
 ILLUSTRATION OF LIST SMALL-GROUP RATING IN THE HIP

| | | List rate pmpm | Employee choice | Employer contribution (lesser of 60% of benchmark or full plan cost) | Employee contribution (List rate minus employer contribution) |
|--------------------|-----------------|-------------------|--------------------|---|---|
| ABC Hauling Co. | Employee Age | | | | |
| | Worker 1 25 | Plan A \$32 | Worker 1 | \$32 | \$0 |
| | Worker 2 40 | Plan B na | | | |
| | Worker 3 60 | Plan C* na | | | |
| | | Plan D \$263 | Worker 2 | \$122 | \$141 |
| | | Plan F \$474 | Worker 3 | \$122 | \$352 |

*Benchmark

2. Composite Rating

The employer would be quoted a composite (group) rate for each available plan as they are now—reflecting the average premium per member, calculated as if the entire group would enroll in each plan. Each employee's contribution would be calculated against the *composite rate* for the plan he selected.

In Figure 2, each of ABC's employees would select a plan, and each would pay a contribution based on the composite rate for the plan he selects. Note that the rate each employee pays no longer reflects his own age. Instead, it reflects the *average* age of workers in the group as well as differences in plan benefits and cost sharing.

FIGURE 2
 ILLUSTRATION OF COMPOSITE SMALL-GROUP RATING IN THE HIP

| | | Composite rate pmpm | Employee choice | Employer contribution (lesser of 60% of benchmark or full plan cost) | Employee contribution (Composite rate minus employer contribution) |
|--------------------|-----------------|------------------------|--------------------|---|---|
| ABC Hauling Co. | Employee Age | | | | |
| | Worker 1 25 | Plan A \$76 | Worker 1 | \$76 | \$0 |
| | Worker 2 40 | Plan B \$102 | | | |
| | Worker 3 60 | Plan C* \$204 | | | |
| | | Plan D \$254 | Worker 2 | \$120 | \$134 |
| | | Plan F \$305 | Worker 3 | \$120 | \$185 |

*Benchmark

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Composite rating for small groups (example #2), which would cross-subsidize workers within the group, would appear to both employers and employees most like the current market. However, employee choice would pose two fundamental problems for carriers in the HIP:

- (a) The age distribution of employees who enroll in a particular plan may bear no resemblance to the mix of employees that selected that plan when the employer's composite rate was established.
- (b) There will be additional adverse selection in more comprehensive plans associated with unrestricted employee choice.

To address these problems, some system of risk adjustment would be needed. Simple prospective risk adjustment could address demographic error in composite rates, associated with (a) above. However, additional, retrospective risk adjustment (based on diagnoses associated with the enrolled population) or reinsurance would be needed to address the problem of adverse selection associated with employee choice, associated with (b).

Note that this latter problem—anticipating adverse selection in employee choice—is not different from what carriers do now in the individual market. However, small group coverage is guaranteed issue, while carriers can deny individual coverage. Because small-group coverage is guaranteed issue, carriers might want risk adjustment or reinsurance to manage unrestricted employee choice in the HIP, even if small-group coverage were list-rated. However, there would be a greater need for risk adjustment or reinsurance if small-group coverage were composite-rated.

B. Employer Contributions to Premiums

With respect to how the employer contribution is calculated, there appear to be two alternatives. Both are consistent with either rating method described above.

1. Percent of Benchmark

As in the examples above, the employer could pay a defined contribution, regardless of what plans employees may ultimately select. In this case, the employer would identify a benchmark plan against which the contribution amount for each employee would be calculated. Employee contributions would vary by the plan he or she selected under list or composite rates; contributions would vary also by employee age under list rates. Employers might prefer this approach, as it would allow them to budget contributions to coverage without potentially costly surprises associated with employee choice.

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2. Percent of Premium for Employee's Plan

The employer might agree to pay at least 40 percent of whatever plan the employee selected. After employees selected their plans, the HIP would present the employer with the bill equal to at least 40 percent of the premium aggregated across all selected plans. It seems likely that employers would not prefer this approach, simply because they could not anticipate their expenditure for health benefits, although there is precedent to expect that some would.³ If employee contributions were calculated against list rates, this approach would reduce “premium shock” for older workers as they move from the current case to the HIP.

A simple example of premiums and employee contributions to premiums associated with alternative carrier rating and employer contribution rules is provided in Table 1. Under simple assumptions about possible variation in list rating for a 2-person group, list rating would produce variation in employee contributions to coverage under either employer contribution rule.⁴ The combination that would be the simplest for both employers and the HIP to administer—list rating with defined employer contributions—would produce the greatest variation in employee contributions to coverage (in the example, 7.9 to 1 for Plan A, and 4.6 to 1 for Plan B).

³ Connecticut's Business and Industry Association Health Connections, a private-sector purchasing organization, allows employers to make either defined contributions to coverage per worker or to pay a percent of premium for any plan that the worker chooses. About half of employers use define contribution, and half pay a percentage of premium for any selected plan (Phil Vogel, personal communication with Amy Lischko). Operated as a division of the Connecticut Business and Industry Association (CBIA) for more than 12 years, Health Connections serves employers with three to 100 employees and provides choice among plans offered by four participating health insurance companies. Currently, more than 6,000 businesses with 88,000 covered lives participate.

⁴ Employer contributions might be calculated to offset rate variation by age, but age-adjusted contributions would be difficult to calculate when there is employee choice and it seems likely that most employers would not take this step.

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TABLE 1
 EXAMPLE OF LIST AND COMPOSITE RATING WITH ALTERNATIVE
 EMPLOYER CONTRIBUTION RULES FOR A HYPOTHETICAL GROUP OF TWO EMPLOYEES

| | Small-group list rating | | Small-group composite rating ^a | |
|---|-------------------------|--------|---|--------|
| | Plan A | Plan B | Plan A | Plan B |
| Total premium | | | | |
| Employee age 25 | \$100 | \$250 | \$238 | \$594 |
| Employee age 60 | \$375 | \$938 | \$238 | \$594 |
| Employer contribution | | | | |
| (1) Employer pays percent of benchmark (defined contribution = \$60 pmpm). Employer pays: | | | | |
| Employee age 25 | \$60 | \$60 | \$60 | \$60 |
| Employee age 60 | \$60 | \$60 | \$60 | \$60 |
| <i>Total employer contribution</i> | \$120 | \$120 | \$120 | \$120 |
| (2) Employer pays 60 percent of employee choice. Employer pays: | | | | |
| Employee age 25 | \$60 | \$150 | \$143 | \$356 |
| Employee age 60 | \$225 | \$563 | \$143 | \$356 |
| <i>Total employer contribution</i> | \$285 | \$713 | \$285 | \$713 |
| Employee contribution | | | | |
| (1) Employer pays percent of benchmark (defined contribution = \$60 pmpm). Employee pays: | | | | |
| Employee age 25 | \$40 | \$190 | \$178 | \$534 |
| Employee age 60 | \$315 | \$878 | \$178 | \$534 |
| <i>Ratio of high to low within group</i> | 7.9 | 4.6 | 1.0 | 1.0 |
| (2) Employer pays 60 percent of employee choice. Employee pays: | | | | |
| Employee age 25 | \$40 | \$100 | \$95 | \$238 |
| Employee age 60 | \$150 | \$375 | \$95 | \$238 |
| <i>Ratio of high to low within group</i> | 3.8 | 3.8 | 1.0 | 1.0 |

Note: Bold-print cells, with small-group composite rating with employer contribution as a percent of coverage, are most similar to the current case.

^a Composite rate does not include the cost of a risk adjustment and/or reinsurance system.

II. Merging the Small Group and Individual Markets

In a merged market, carriers would be required to rate small group employees and individuals in the same way under small group regulations. However, the HIP rating rules do not require carriers to spread risk within a small group by using composite rating. (Carriers and employers choose to use composite rating in the current small group market.) Depending on how small-group coverage is rated in the HIP, older enrollees especially will experience “rate shock” when moving to individual coverage, much as they do today. Therefore, portability between group and individual coverage in the HIP could be less than might have been anticipated.

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How rates are set in the small-group market and how employers contribute will affect the magnitude of the rate shock when moving from small group to individual coverage in the HIP. If small-group is list rating, carriers would offer individuals and small-group employees identical rates for the same products, and employers could pass the list rates on to their employees (as the example in Figure 1 assumed). Because individual coverage also is list rated, the difference in the amount that a worker would pay for the same coverage in a small group would differ from his individual premium only by the amount of the employer contribution.

However, if small-group coverage is composite-rated, small-group rates would appear to differ from the rate charged to individuals: small-group employees would see a rate that pools age-related risk within their group, while individuals would see a rate related to their own age. The rate differences for comparable coverage that workers experience now when moving from group to individual coverage would continue to exist.

An example of the differences in rates that might occur for a worker at age 60 under these alternative rules for small-group and individual rating is presented in Table 2. The example carries over the same premium levels for 60 year-olds from Table 1.

If small-group coverage is list-rated and employers used a *defined-contribution* approach to funding their small group plans, a 60-year old worker moving from small group to individual coverage in the HIP would experience a premium increase of 19 percent for Plan A and 7 percent for Plan B. If employers pay a *percent of premium* for the employee's chosen plan, then the change in premium will be greater when the employee moves to individual coverage. In our example, premiums paid by individuals in Plans A and B would be 150 percent greater than the contributions they paid as covered workers. In both cases, regardless of the contribution rule, the larger the employer contribution, the larger the jump in employee payments when moving from group to individual coverage. However, when both employees and individuals are list rated, the employee is not *also* moving from a composite rate to an individual list rate.

If carriers use small-group composite rating in the HIP and employers pay a percent of the benchmark plan (*defined contribution*), then premiums for a 60-year-old employee moving from group to individual coverage in the HIP (in our example) would increase 211 percent for plan A and increase 176 percent for Plan B. If employers paid a *percentage of premium* for any plans that their employees selected, premiums would increase 295 percent when moving from small group to individual coverage. *Note that this scenario is most similar to the current small group market, without the HIP.* If employers paid a still higher percentage of premium (not shown), the increase would be still greater.

Note that, when moving to individual coverage, the difference between a lower increase (in our example, 150 percent) and a much higher increase (295 percent) for an older worker is entirely due to use of composite rating. To eliminate that difference, HIP would need to apply list rating to small groups, although alternative options also exist for reducing rate shock when moving from small-group to individual coverage. These would include pure community rating

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or compressing the allowable difference between rates for old and young enrollees. The Board might choose to discuss these rating options when it reviews the results of the Preliminary Study.

TABLE 2
 EXAMPLE OF ALTERNATIVE RULES FOR SMALL-GROUP RATING, EMPLOYER CONTRIBUTIONS
 AND INDIVIDUAL LIST RATES FOR A HYPOTHETICAL WORKER AT AGE 60

| | Small-group list rating | | Small-group composite rating | |
|--|-------------------------|-------------|------------------------------|--------------|
| | Plan A | Plan B | Plan A | Plan B |
| Total premium | | | | |
| Employee age 60 | \$375 | \$938 | \$238 | \$594 |
| Individual age 60 | \$375 | \$938 | \$375 | \$938 |
| Employer contribution | | | | |
| (1) Employer pays percent of benchmark (defined contribution = \$60 pmpm). Employer pays: | | | | |
| Employee age 60 | \$60 | \$60 | \$60 | \$60 |
| Individual age 60 | \$0 | \$0 | \$0 | \$0 |
| (2) Employer pays 60 percent of employee choice. Employer pays: | | | | |
| Employee age 60 | \$225 | \$563 | \$143 | \$356 |
| Individual age 60 | \$0 | \$0 | \$0 | \$0 |
| Employee/individual contribution | | | | |
| (1) Employer pays percent of benchmark (defined contribution = \$60 pmpm). Employee/individual pays: | | | | |
| Employee age 60 | \$315 | \$878 | \$178 | \$534 |
| Individual age 60 | \$375 | \$938 | \$375 | \$938 |
| <i>Increase from group to individual rate</i> | <i>19%</i> | <i>7%</i> | <i>111%</i> | <i>76%</i> |
| (2) Employer pays 60 percent of employee choice. Employee/individual pays: | | | | |
| Employee age 60 | \$150 | \$375 | \$95 | \$238 |
| Individual age 60 | \$375 | \$938 | \$375 | \$938 |
| <i>Increase from group to individual rate</i> | <i>150%</i> | <i>150%</i> | 295% | 295% |

Note: Bold-print cells—with small-group composite rating with employer contribution as a percent of coverage, and individual list-rating—are most similar to the current case.

^a Composite rate does not include the cost of a risk adjustment and/or reinsurance system.

Reviewing a similar example for a 25-year old raises an additional issue: incentives for young workers to take group coverage versus buying individual coverage in the HIP. Table 3 presents the same kind of example as in Table 2, but for a 25-year old worker and an individual of the same age. Note that with composite rating for small groups and list-rating for individuals, individual coverage would be either approximately as expensive or much less expensive for a 25-year-old worker, depending on the employer contribution method. This circumstance is not different from the small-group and individual markets currently. In contrast, with small-group list rating, the worker moving from small-group to individual coverage in the HIP would pay more only because he would lose his employer contribution; otherwise, he would pay the same premium as an individual as he did as a covered worker.

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TABLE 3

EXAMPLE OF ALTERNATIVE RULES FOR SMALL-GROUP RATING, EMPLOYER CONTRIBUTIONS
 AND INDIVIDUAL LIST RATES FOR A HYPOTHETICAL WORKER AT AGE 25

| | Small-group list rating | | Small-group composite rating | |
|--|-------------------------|-------------|------------------------------|--------------|
| | Plan A | Plan B | Plan A | Plan B |
| Total premium | | | | |
| Employee age 25 | \$100 | \$250 | \$238 | \$594 |
| Individual age 25 | \$100 | \$250 | \$100 | \$250 |
| Employer contribution | | | | |
| (1) Employer pays percent of benchmark (defined contribution = \$60 pmpm). Employer pays: | | | | |
| Employee age 25 | \$60 | \$60 | \$60 | \$60 |
| Individual age 25 | \$0 | \$0 | \$0 | \$0 |
| (2) Employer pays 40 percent of employee choice. Employer pays: | | | | |
| Employee age 25 | \$60 | \$150 | \$143 | \$356 |
| Individual age 25 | \$0 | \$0 | \$0 | \$0 |
| Employee/individual contribution | | | | |
| (1) Employer pays percent of benchmark (defined contribution = \$60 pmpm). Employee/individual pays: | | | | |
| Employee age 25 | \$40 | \$190 | \$178 | \$534 |
| Individual age 25 | \$100 | \$250 | \$100 | \$250 |
| <i>Increase from group to individual rate</i> | <i>150%</i> | <i>32%</i> | <i>-44%</i> | <i>-53%</i> |
| (2) Employer pays 60 percent of employee choice. Employee/individual pays: | | | | |
| Employee age 25 | \$40 | \$100 | \$95 | \$238 |
| Individual age 25 | \$100 | \$250 | \$100 | \$250 |
| <i>Increase from group to individual rate</i> | <i>150%</i> | <i>150%</i> | <i>5%</i> | <i>5%</i> |

Note: Bold-print cells—with small-group composite rating with employer contribution as a percent of coverage, and individual list-rating—are most similar to the current case.

^a Composite rate does not include cost of a risk adjustment and/or reinsurance system.

The incentive for younger workers to forego composite-rated group coverage for list-rated individual coverage demonstrates the importance of tax incentives for holding groups together with composite rating. We assume that employers that offer a Section 125 plan and group coverage will allow eligible workers to use the Section 125 plan *only* to pay contributions and cost sharing in the group plan, as they typically do now—although employees not eligible for the group plan would have access to a premium-only plan for the purpose of paying individual premiums. Absent this assumption, how small-group coverage is rated in the HIP could affect the ability of employers to retain young workers in small group (versus individual) coverage.

Finally, in our conversations with carriers, it was noted that merging the market for small groups and individuals would substantially increase premiums for individuals for at least two reasons:

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- (1) Individuals are now underwritten and denied coverage in Washington, and the same underwriting would continue in the HIP. In contrast, small groups are guaranteed issue, and would continue to be guaranteed issue. Therefore, individuals—offered the same products at the same prices—would subsidize small groups in the HIP.
- (2) Products available in the HIP may be more generous than those now available in the market—which can have deductibles well above HSA-qualification standards.

The increase in benefits, together with subsidization of small groups would predictably cause a very high increase in premiums for individuals in the HIP.

For the purpose of the Board studies, offering individuals and small group enrollees in the HIP the same products at the same premiums—but retaining individual underwriting—may be a provision that cannot be altered. However, the Board should anticipate that a very high increase in individual premiums could result.

III. ADDITIONAL HIP BOARD GUIDANCE NEEDED FOR MODELING HIP

We request additional guidance with respect to the following three questions:

- 1. What small-group rating method should be assumed?**
 - a. List rating
 - b. Composite rating with risk adjustment/reinsurance
- 2. If small-group composite rating is assumed, should the cost of administering prospective and retrospective risk adjustment and/or reinsurance be included in the estimated premium, as it would be clearly necessary to sustain this rating method?**
- 3. What rule for employer contributions to premium should be assumed?**
 - a. Defined contribution
 - b. Percentage of premium, regardless of employee choice
 - c. Either, as determined by the employer

To assist in considering these questions, we distill the information presented in this memorandum in Table 4.

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TABLE 4

SUMMARY OF LIKELY EFFECTS FROM RATING AND EMPLOYER CONTRIBUTION RULES IN THE HIP

| <i>Small-group rating:</i> | List | Composite |
|---|---|--|
| <i>Individual rating:</i> | List | List |
| Small group rate levels relative to baseline | Workers within group will pay different rates unless employer contribution offsets age-adjusted rate. Otherwise, older workers may take reduced coverage. | No change |
| Individual rate levels relative to baseline | No change | No change |
| Portability: Rate shock moving from small group to individual coverage | | |
| <i>Employer contribution is:</i> | | |
| Defined contribution | Minimum rate change | Medium rate change |
| Percent of chosen plan premium | Low-medium rate change | Maximum rate change (similar to current case) |
| Burden of administration | | |
| Employers | Moderate change | No change |
| HIP | Low, although higher if carriers would want risk adjustment and/or reinsurance to manage small-group employee choice. | High: risk adjustment and/or reinsurance needed. |

cc: Amy Lischko, Vicki Wilson, MPR project team